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IN THE

Supreme Court of the United States

October Term, 1965
No. 487

WILLIAM MALAT and ETHEL MALAT,

Petitioners,

vs.

ROBERT A. RIDDELL, District Director of Internal Revenue,

Respondent.

PETITIONERS' OPENING BRIEF.

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PETITIONERS' OPENING BRIEF.

Opinions Below.

The opinion of the District Court [R. 8-17] is not officially reported. The opinion of the court below is reported at 347 F. 2d 23.

Jurisdiction.

This case involves a suit for refund of income taxes. The suit was filed in the United States District Court for the Southern District of California. A judgment of that court dismissing the action was entered April 21, 1964 [R. 25-26]. A notice of appeal to the United States Court of Appeals for the Ninth Circuit was filed May 7, 1964 [R. 26]. A judgment of affirmance by that court was entered May 27, 1965 [R. 35]. A petition for certiorari was filed in this court August 23, 1965. The order allowing certiorari was entered November 8, 1965 [R. 36]. The jurisdiction of this court is based on 28 U.S.C. §1254(1).

Statutes Involved.

26 U.S.C. (Internal Revenue Code of 1954), §1221. Capital asset defined.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; . . .

Questions Presented.[1]

(1) Whether the finding that the venturers "intended either to sell the property or develop it for rental, depending upon which course appeared to be most profitable," can survive in the face of (a) the finding that if the property proves ultimately incapable of commercial development the venturers would sell the whole thing off in bulk so as not to get hurt, and (b) the complete absence of a single word in the record showing an intention to sell for the purpose of profit.

(2) Whether the term "held primarily for sale," as used in section 1221(1), Internal Revenue Code of 1954, embraces an intent of the taxpayer, in connection

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[1]Question 1 above is based on Reason 3 in the Petition for Certiorari beginning therein at page 10, and Question 1 in the Petition for Certiorari is now treated as embraced within Question 2 in that Petition.

with the acquisition of property by him for development for rental, that if the property proved ultimately incapable of such development because of failure to obtain the requisite rezoning or refinancing, he would sell the whole thing off in bulk so as not to get hurt.

(3) Where the taxpayer's intent to sell arises for the first time when he enters into the agreement to make the sale involved, the property not having been previously held for sale, directly or indirectly, to anyone, is the property then held primarily for sale to customers in the ordinary course of trade or business within the meaning of section 1221(1)?

Statement.

In order to avoid burdening this court with an unnecessary recitation of the facts, we adopt as far as it goes, and quote, the following summary of the facts with which the Court of Appeals began its opinion [R. 29-31]:

> "The case involves income tax for the year 1956. The taxpayer[2] had reported the gain on the transaction in question as capital gain. The Internal Revenue Service disagreed. A deficiency was assessed and was paid by the taxpayer. This suit for recovery followed.
>
> "Taxpayer at all times pertinent to this case was a member of Louis Lesser Enterprises, Ltd., a partnership (to which we shall refer as 'Lesser'), which for some time as a business enterprise had

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[2]William Malat is referred to as the taxpayer. His wife is joined since a joint return was filed."

been engaged in the purchase and development of real estate for rental.[2]

"In 1953 Lesser and four individuals not members of the partnership negotiated for the purchase of 44.901 acres of agricultural land, located at Century and Crenshaw boulevards in Inglewood, California. On August 12, 1953, they organized Century-Crenshaw Plaza as a joint venture, entered into agreement for purchase of the property for the sum of $486,000 and established an escrow for that purpose. At the time of the establishment of the escrow the land was zoned agricultural. A condition to the closing of the escrow was that it be rezoned as residential, and that a corner parcel retained by the seller, 600 x 600 feet, be rezoned as commercial. These changes in zoning were accomplished and the escrow was closed on February 15, 1954.

"In the meantime the intentions of the venturers with respect to the land had undergone a series of changes.

"At the outset, as taxpayer testified, they 'had in mind' a garden-type apartment development of the entire property—a single-mortgage development, requiring no division of the property into separate

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[2]In respect to the business of petitioners themselves the memorandum opinion of the District Court contains the following [R. 11]:

"Plaintiffs, in the case at bar, have for a number of years, been engaged in the purchase of property for development as an investment. They have frequently held interests as partners and stockholders in businesses holding properties for development and income where, in isolated cases, a portion of the unimproved real estate was sold as lots or raw land. The evidence shows that such sales were infrequent. The court recalls only three being referred to by plaintiff."

parcels. This was contingent not only on their securing zoning changes (in which they were successful) but (since they were themselves in no position to finance the project) also on their ability to secure adequate financing. In this respect they first sought the assistance of the Federal Housing Administration but found that they could not secure FHA guarantees on terms acceptable to them. They next sought conventional financing. Their efforts, through mortgage brokers and savings and loan associations, failed. As taxpayer testified, 'The mortgage market was very, very soft then, very tight.' They then abandoned their original idea of a single-mortgage project. Taxpayer testified: 'Our next thought was to build individual apartments, 4-, 6-, 8-unit buildings and finance each one with a separate mortgage.[3]' This involved carving out an inner parcel of 20 to 25 acres for the apartment buildings and retaining the two frontage areas on Century and Crenshaw boulevards for commercial use. A subdivision map covering the inner parcel was presented to the City of Inglewood and approved. For two reasons, this idea also had to be abandoned. The rezoning of the frontages could not be secured. Also, despite all efforts, the venturers were still unable to secure financing.

"They were now faced with interest charges on their trust deed and with the cost of street improve-

[3]As to the venturers' objective at this point the same witness testified [R. 49]:

"Well, our objective was the same on an individual building basis, as it was on a project basis, was to develop the property into apartments, apartment buildings that we could keep and collect rents on."

ments and like subdivision expenses. Taxpayer testified 'So we took the next best route, * * * and proceeded to sell the lots, the individual lots in the subdivision.' The frontage parcels were retained, still in hope that commercial zoning could be secured as to them. The prospects of rezoning remained discouraging and a rift developed among the venturers: Lesser and two individuals 'wanted to get out and be done with it.' The other two wished to hold on. Eventually those who wished to get out, including Lesser, sold out their interests.

"The gain which the venturers had realized on sale of the subdivision lots had been reported as ordinary income and is not here involved. Our sole concern is with the gain realized on the sale of the two frontage parcels."

The Court of Appeals then quoted the following testimony of petitioner Malat taken in a deposition by respondent, read into the record by respondent, and pointed to in the Court of Appeals by respondent [R. 31, 116]:

"'Q. Mr. Malat, at the time that you were considering the zoning potential and the development potential of this property, did you contemplate, in acquiring the property, the possibility that rezoning or refinancing, or whatever, might not be possible? A. This is always a possibility in real estate development.

Q. And what was your intention if that couldn't —I mean, you must have considered this as well. A. Well, this was a bridge that we all felt we would cross when we came to it. We would first do the things—we felt that we had made a good

buy on the property as far as price is concerned, so that if we couldn't do anything in the way of zoning, we would sell the whole thing off in bulk. We wouldn't get hurt. So, there was no urgency. There was no need to say, "Well, if this doesn't happen, and that doesn't happen—we took one step at a time." ' "

The above quotation comprises the only evidence, absolutely the only evidence, of any idea of the venturers, at the time of acquisition, that sometime they might sell the property. And even that idea, however it might be framed, disappeared. This the District Court itself brought out, in the course of the trial. This occurred as follows [R. 90-91]:

"By Mr. Bay [for respondent]:

Q. Was it your intention to develop both the Century portion and the Crenshaw portion as commercial, or just the Century portion as commercial? A. No, we had hopes that both parcels could be zoned. They both fronted on major arteries and were susceptible to good commercial development, if the zoning were obtainable.

Q. Well, don't we get down to the basic point, that the only reason you were intending to or the only reason you sold the property was that you were having a rift among the partners because you were holding the property, waiting for the zoning situation—

The Court: That is what he said, I think. He said that was the reason that they sold it, isn't that right?

The Witness: That is the only reason. We could well—

The Court: That was the only reason, they had a dispute.

The Witness: We could well still be sitting with that property waiting to develop it if there had been a rapport among the partners. We weren't pressed for cash."

Also [R. 120]:

"By Mr. Altman [for petitioners]:

Q. Mr. Malat,—

The Court: He says, Mr. Altman, and it is very clear, he said more than once the reason they sold it was because of the acrimony and the dispute and the ill feeling between the partners.

Mr. Altman: Yes.

The Court: That is the reason they sold it. They had this plan and they would have held it and made R-3 if they couldn't get the commercial zoning."

Thus the idea of the venturers, at the time of acquisition, that if their plan for development failed, they would sell the property off in bulk,—even that idea vanished and there was left solely their intention to hold for development.

It is in that factual situation that we come to the two sales involved here. One of them was to the continuing partners, Hicks and Fenmore [R. 23-24], the other was to a business associate of the said Hicks [R. 65-66], and both were made solely at the instance and request of the said Hicks [R. 64-66, 118]. Neither of the courts below said that those sales were sales to customers, or in the ordinary course of business. Indeed, the Court of Appeals interpreted them as in effect

sales of partnership interests, instead of the land itself, saying, as above quoted [from R. 30]: "Eventually those who wished to get out, including Lesser, sold out their interests."

The District Court had, however, on the basis solely of the testimony quoted at pp. 6-7 above as testimony quoted by the Court of Appeals, made the following finding [R. 22]:

> "11. The members of Plaza, as of the date the 44.901 acres were acquired, intended either to sell the property or develop it for rental, depending upon which course appeared to be most profitable. The venturers realized that they had made a good purchase price-wise and, if they were unable to obtain acceptable construction financing or rezoning from 'R-3' to 'C-2' which would be prerequisite to commercial development, they would sell the property in bulk so they wouldn't get hurt. The purpose of either selling or developing the property continued during the period in which Plaza held the property."

In the Court of Appeals petitioners did not challenge the second sentence of that finding, as showing an intention of the venturers at the time of acquisition; but they did challenge, as contrary to the record, the first and last sentences thereof, and the District Court's conclusion of law [R. 24] that petitioners had failed to establish that the property was not held by the venturers primarily for sale to customers in the ordinary course of their trade or business.

Summary of Argument.

The finding of a dual purpose, "to sell the property or develop it for rental, depending upon which course appeared to be most profitable," is in conflict with the finding that if the venturers failed to develop the property for rental they would sell it off "in bulk so they wouldn't get hurt." A purpose to sell for profit is also unsupported by a single word in the record. Thus the dual purpose finding is not one drawn from the evidence but one induced by a view of the law, and is not a part of the facts at all.

In the context here, that is, as used in Section 1221 (1) of I.R.C. 1954, the term "primarily" means, in accordance with common usage, "of first importance or principally," and the purpose to develop for rental was, on the basis of the trial court's own evidentiary findings, the purpose "of first importance" here. Indeed, there was here, as the evidence called forth by the trial court itself shows, no holding for sale at all during the period preceding the sales involved.

The actual sales involved here were, in effect, as the Court of Appeals itself viewed them, p. 6, *supra,* sales of partnership interests rather than of the real property itself. Clearly they were neither sales to customers nor in the ordinary course of trade or business. Therefore the resolve to make those sales could not be evidence of a holding primarily for sale to customers in the ordinary course of trade or business. Moreover, if a prior purpose to sell "became" the primary purpose by virtue of that resolve, as the Court of Appeals asserts, it begs the question whether at the time of that resolve sale of any kind to anyone was the primary purpose of the holding.

ARGUMENT.

1.

The Dual Purpose Finding of the District Court, That the Venturers "Intended Either to Sell the Property or Develop It for Rental, Depending Upon Which Course Appeared to Be Most Profitable," Is Not One Drawn From the Evidence, but One Induced by a View of the Law, and Is Therefore Not a Part of the Facts at All.

The finding of an alternative intent to sell for the purpose of profit, contained in the finding that the venturers "intended either to sell the property or develop it for rental, depending upon which course appeared to be most profitable," is in clear conflict with the finding, contained in the very same paragraph of the findings, that if financing or rezoning could not be obtained for commercial development the venturers "would sell the property in bulk so they wouldn't get hurt." A purpose to sell if that is "most profitable" is inconsistent with a purpose to sell "so they wouldn't get hurt."

In the second place, the finding of a purpose to sell if that is "most profitable" is not supported by a single word in the entire record. Nowhere is there a word, not a word, which even indirectly points to a purpose to sell in order to make a profit. The Court of Appeals failed to point to such a word. Its extended and tortuous reasoning over this very simple problem of fact is but further indication of its failure to discover anything in the record actually showing such a fact's existence.

It is clear then that the said finding was not one drawn from the evidence, but one induced by a view of the law. It does not belong in the facts at all. *United*

States v. U.S. Gypsum Co., 333 U.S. 364, 394, 68 S. Ct. 525, 541. Indeed, it is *a non sequitur* so gross that an issue of due process could properly be raised in respect to it. *Tot v. United States*, 319 U.S. 463, 467, 63 S. Ct. 1241, 1245.

The said finding was one without which each of the courts below, on its own opinion, would obviously have decided the other way. The decision below is reversible, on that ground alone.

2.

In the Context Here the Term "Primarily" Means "of First Importance or Principally;" and Property Is Not "Held Primarily for Sale" Where the Only Thought of Sale Is the Idea of the Taxpayer, at the Time of Acquisition, That He Possibly May Have to Sell the Property if, at Some Indefinite Time in the Future, It Proves Ultimately Incapable of Development for Rental.

The word "primarily" first appeared in connection with capital gains in the Revenue Act of 1924.[4] It

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[4]The separate classification of "capital assets" under the federal income tax began with the Revenue Act of 1921. This court had held gain realized on the sale or conversion of capital assets to be income and therefore subject to a tax on income. *Doyle v. Mitchell Bros. Co.* 247 U.S. 179, 185, 38 S. Ct. 467, 469; *Eisner v. Macomber*, 252 U.S. 189, 207 40 S. Ct. 189, 193. Viewing the graduated rate schedule of the federal income tax as an impediment to sales and exchanges of such assets Congress, in the Revenue Act of 1921, gave them a favored status. 61 Cong. Rec. 6575-6. Under Section 206(b) of that act the tax on gains derived from the sale or exchange of capital assets was limited to 12½%, and under section 206(a)(6) thereof the term "capital assets" was defined to mean "property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business)" except "property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other

effected an extension of the term "inventory" to property not included in inventory under good accounting practice, such as real estate, O.D. 848, 4 CB 47 (1921), but held for the same purpose. This was thus an extension of the inventory concept to such property for the purpose of the exclusion from capital-asset classification.

This court has held that in the interpretation of statutes a court's "problem is to construe what Congress has written," that "Congress expresses its purpose by words," and that it is for the court "to ascertain—neither to add nor to subtract, neither to delete nor to distort." *62 Cases, etc. v. United States,* 340 U.S. 593, 596, 71 S. Ct. 515, 518. More directly this court stated, when it came to determine the meaning of the word "property" as used in an income tax statute:

> "In the first place, the words of statutes—including revenue acts—should be interpreted where pos-

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property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."

In order to remove from capital-asset classification, property which under good accounting practice would not be included in inventory, but which nevertheless was not truly capital-asset, there was added to the exclusions from such classification, under section 208(a) of the Revenue Act of 1924, "property held by the taxpayer primarily for sale in the course of his trade or business." 68th Cong., 1st Session, House Report No. 179, p. 19, Senate Report No. 398, p. 22.

This added exclusion went too far, Congress concluded when it came to writing the Revenue Act of 1934. The reason was that it operated to deny capital-asset classification to property held by the taxpayer for resale otherwise than to customers of his, as securities held by the taxpayer for trading through brokers on his own account. To correct this the exclusion was limited by insertion of the words "to customers" and "ordinary," so that it now reads as follows: "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." 73rd Cong., 2d Session, House Report No. 1385, p. 22.

sible in their ordinary, everyday senses. The only relevant definitions of 'property' to be found in the principal standard dictionaries are the two favored by the Commissioner."

Crane v. Commissioner of Internal Revenue, 331 U.S. 1, 6, 67 S. Ct. 1047, 1051; followed in *Hanover Bank v. Commissioner,* 369 U.S. 672, 687, 82 S. Ct. 1080, 1089. Nor has this court ever held, for the purpose of either a narrow or a broad construction, that a term in a statute could be given a sense not provided by either the statute itself or known and relevant usage.

Examining the various dictionaries[5] here, three points are clear: (1) that the adverb "primarily" has a narrower scope than the adjective "primary," the adverb picking up, in fact, only the more common meanings of the adjective; (2) that both the adverb and the adjective may have a meaning in one context which they do not have in another; and (3) that if a thing is secondary it is not primary.

It is significant also that in not a single dictionary is the word "primarily" defined as "substantially," or the word "primary" as "substantial." This court has, it is true, in another context gone by mesne process from "primarily" to "substantial." This was *Board of Governors v. Agnew,* 329 U.S. 441, 67 S. Ct. 411. The statute involved there was the provision of the Banking

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[5]Webster's Third New International, Webster's New World (College Edition), Oxford English, Oxford Universal, Funk & Wagnall's, Brittanica World Language Edition of Funk & Wagnall's Standard, American Encyclopaedic, Standard, Century, New Century, Universal, Johnson's, Chamber's Twentieth Century, Virtue's English (Encyclopaedic Edition), The New Elizabethan Reference, Swan's Anglo American, A New English (on Historical Principles), The American College, Evans (A Dictionary of Contemporary American Usage), Bouvier's Law, Black's Law.

Act prohibiting, *inter alia*, any partner or employee of a partnership "primarily" engaged in underwriting from serving also in banks; and the case presented the question whether the entity involved there was "primarily engaged" in the underwriting business, although that business represented, quantitatively, less than 50 per cent of its total gross income. Going from the word "primary," by way of dictionaries, to "essential" and "fundamental," this court then reasoned that in the particular context the latter words must include "substantial" because otherwise the firm was not primarily engaged in any business, because firms which do underwriting normally engaged in other activities, and because the very same act, in a separate provision, specially limited firms which were "engaged principally" in the underwriting business. This led this court there to conclude: "If the underwriting business of a firm is substantial, the firm is engaged in the underwriting business in a primary way though by any quantitative test underwriting may not be its chief or principal activity." 329 U.S. at p. 446, 67 S. Ct. at p. 414.

In the case here, however, the context is wholly different; the question is, as to each of two specific pieces of property, the purpose for which that piece of property was primarily held, and this regardless of the purpose for which other pieces of property were held, or the business in which the taxpayer was primarily engaged. Senate Report No. 781, 82d Cong., 1951-2 C.B. 458, 482, ¶ 4; Rev. Rul. 57-565, 1957-2 C.B. 546. As to each sale the relevant purpose would be the one for which it was held during the period immediately preceding the sale. 3B Mertens §22.138, at fn. 89. Obviously a sale can result, as clearly the sales involved

here did, from factors other than a purpose of holding for sale, particularly holding for sale to customers in the ordinary course of trade or business. There is just no way of applying here the sentence quoted above from *Agnew.*

Also, there was not here, as in *Rollingwood Corp. v. Commissioner* (C.A. 9), 190 F. 2d 263, 264, a course of sales of the properties involved which by contract, statute, operating necessity, or otherwise was indissolubly part of and tributary to the day-to-day income-producing activities of the taxpayer, so that a trial court could not separate it or separately weigh it. Because of that situation in *Rollingwood,* in which the lease contracts, pursuant to statutory requirement, contained an option to the lessee to purchase, we have no need to consider that case here. It was, in fact, but a variant of the situation of sales of corn futures held for inventory support, involved in *Corn Products Refining Co. v. Commissioner,* 350 U.S. 46, 76 S. Ct. 20.[6] For that reason the court in *Rollingwood* had no need to define "primarily" as "substantially."

We submit that in the context here the term "primarily" means, as it did in *Municipal Bond Corporation v. Commissioner* (C.A. 8), 341 F. 2d 683, 687, and as the dictionaries show to be its common, chief, non-temporal sense, "of first importance or principally";

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[6]We take no issue with the holding in the *Corn Products* case, 350 U.S. at p. 52, that the exclusions from capital-asset classification are to be interpreted broadly, that is, in favor of the revenue. We have no such problem here.

and that sale to customers in the ordinary course of trade or business was clearly not such a purpose here. On the contrary, there was here, during the period preceding the sale, no purpose of sale at all, let alone as the primary purpose, let alone to customers, and let alone in the ordinary course of trade or business.

3.

Finally, the Court of Appeals Erred in Assuming That the Actual Sales Involved Here Made Sale the Primary Purpose of the Holding.

What the Court of Appeals said was that [R. 35] "when taxpayer resolved to sell, that purpose . . . became the primary purpose and the property was primarily held for the purpose of sale." The necessary assumption would be that previously it was not the primary purpose. But the resolve to sell here, except as a step in the course of entering into the actual sales involved, had no existence at all. Clearly then the said statement of the Court of Appeals begs the question whether at the time of the sales the purpose of sale was the primary purpose of holding.

The actual sales here, moreover, were neither to customers nor in the ordinary course of trade or business. Neither court below said that they were; it is clear that neither could say so. Obviously then those sales could not be proof of a purpose, whether or not primarily, to hold for sale to customers in the ordinary course of trade or business.

Thus by no feat of logic or illogic can the actual sales involved here, or the resolve to make them, be evidence of a purpose, required for denial of capital-gain treatment, to hold primarily for sale to customers in the ordinary course of trade or business. In this also the Court of Appeals clearly erred.

Conclusion.

We submit in conclusion that the courts below clearly erred, that the property sold could not be classified as other than "capital assets," and that the judgment entered should therefore be reversed.

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Attorney for Petitioners.

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